No. 14,913

IN THE

United States Court of Appeals

For the Ninth Circuit

KEENAN PIPE & SUPPLY COMPANY,
a corporation,
Appellant,

vs.

B. E. SHIELDS, as Trustee in Bankruptcy of James T. Inman,
Appellee.

APPELLEE'S BRIEF.

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Subject Index

Table of Authorities Cited

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STATEMENT AS TO JURISDICTION.

Appellee adopts in its entirety the statement of appellant as to jurisdiction.

STATEMENT OF THE CASE.

The voluntary petition in bankruptcy of James T. Inman was filed on October 17, 1953. Appellee B. E. Shields subsequently was duly appointed trustee.

During the times pertinent to this controversy Inman was active as a plumbing subcontractor. During the same period, one John H. Deeter, a general con-

tractor, contracted with Inman for the performance of certain plumbing work. This work consisted of subcontract work on private residences and on a certain public construction job designated as the "California State Epileptic Hospital" at Porterville, California.

On July 8, 1953, final payment for the Porterville Hospital project had not yet been received by general contractor Deeter. (Tr. p. 84.) At this juncture there was due to Inman from the general contractor Deeter on account of the Porterville Hospital job the sum of $5,416.63. (Tr. p. 84.) On July 8, 1953, Deeter executed and delivered a check for that sum jointly payable to Inman and appellant, Keenan Pipe Company, pursuant to a prior agreement between the parties that Inman's materialmen would be paid by means of check jointly payable to Inman and the materialmen.

On September 4, 1953, there was due from Inman to appellant on account of plumbing materials and supplies used in the construction of private residences being built by Deeter as general contractor the sum of $769.01. On that date Deeter paid over the same amount by a check payable to appellant.

At the time of these payments Inman owed Federal and State taxes in the amount of $4,539.94, an account payable to appellant Keenan Pipe Company of $13,306.08, $500.00 to the Anglo Bank, $600.00 to Bank of America, back rent of $700.00, $1500.00 to a firm known as Tay-Holbrook, $2,650.00 to a firm known as Bernstein Plumbing, a total of $23,796.02. In

assets Inman had an equity in his home which practical experience proved was worthless, despite the fact that, in his personal estimation, the home should have brought $3,000.00 more than was due on it. He had stock-in-trade valued at $1200.00 at most, and an account receivable on the Porterville job of $5,416.63, and accounts receivable for miscellaneous private jobs of $769.01, or a total of $14,885.64 allowing the maximum on the equity in home, tools, and autos. (Tr. pp. 23-30, 35-40, 54-55, 59.)

Prior to the payment to appellant of the two amounts in issue, Inman and his wife repeatedly advised Mr. Keith, agent of the appellant, of their financial difficulties, of their inability to pay their bills as they came due, and of their contemplation of bankruptcy. (Tr. pp. 31-34, 56-59.)

As the result of the two payments, appellants received a greater percentage of the amounts due them than will the creditors of the bankrupt who must rely on the assets of the estate, since a dividend of far less than one hundred per cent will be paid. (Tr. p. 93.)

ARGUMENT.

I. INTRODUCTION.

The essential question here presented is whether mechanics or materialmen who forego the exercise of lien or stop notice rights arising from a construction project in favor of accepting payment from their

subcontractor have special grounds for avoiding the preferential transfer statute when the bankruptcy of the subcontractor later occurs.

In addition to answering this broad question in the affirmative, appellant finds comfort of a cumulative nature in the special facts of the present controversy. We will deal with these as we proceed.

It would appear useful to orient the discussion which follows in terms of these two issues of law:

(a) Was there no such a depletion of the estate of the bankrupt as is required by Section 60 of the Bankruptcy Act?

(b) Even if otherwise there was such a depletion, does Section 67-b of the Act extend special protection to transferees in the category of appellant?

Appellant asks that this Court reverse the position taken by it in *San Mateo Feed and Fuel Co. v. Hayward,* 149 Fed. 2d 875, and answer both questions in the affirmative. We propose to establish that the rule in the *San Mateo Feed* case should stand.

II. WAS THERE A DIMINUTION OF THE ESTATE?

It is too well established to require detailed citation that in addition to the explicit requirements of Section 60, the challenged transfer must have caused an actual depletion of the estate. (3 *Collier on Bankruptcy* 14th Ed. 832.) Thus if a debtor were to satisfy a mechanic's lien against his own home, the increase in the value of the property would offset the loss of

money and no preference would occur. The question, then, is whether this appellant materialman had a lien on any asset of the bankrupt.

A. A Statutory Lien?

The assets of the bankrupt conceivably subject to lien are the accounts receivable owed by general contractor Deeter to the bankrupt, being money due for plumbing work on a public project, and a collection of small amounts due for work done on private residences. Did appellant have a lien on these accounts receivable?

The lien arising out of the public project was in the form of a stop notice which could have been filed with the State of California against moneys due general contractor Deeter from the State. *It has been expressly held in California that a materialman who furnishes materials to a subcontractor in a building cannot, by means of stop notice, intercept the moneys which may be due from the contractor to the subcontractor.* (*Kruse v. Wilson,* 3 Cal. App. 91.) This Honorable Court adopted the *Kruse* case as a correct statement of California law in *Malott and Peterson v. Street,* 4 Fed. 2d 770.

In the case of the payment for work done on private residences, it is even plainer that no asset of the bankrupt was subject to the lien rights of appellant. The mechanic's liens, of course, would be encumbrances on the residences themselves.

B. An Equitable Lien?

Appellant finds in the Transcript evidence of an agreement between the contractor, the debtor, and appellant that the money to be paid appellant would be paid specifically from the money paid by the State. Pages 81 and 83 are cited in this connection. We do not perceive the agreement with the same clarity, and we note that in actual fact the contractor Deeter paid appellant on account of the debtor before the money from the State was even received. (Tr. p. 84.) But ignoring that, and assuming the contract to have been exactly as appellant contends, we cannot find aid for appellant in the present state of the law.

The theory apparently relied on is that the agreement between the parties, made outside the four months period, perfected the transfer to appellant by virtue of the equitable lien arising therefrom. At an earlier time in the history of the Bankruptcy Act this theory would have had considerable merit in the instant circumstances. But appellant, in citing such cases as *U. S. Fidelity and Guaranty Co. v. Sweeney,* 80 Fed. 2d 235 (1935), *McClure v. Heim Overly Realty Co.,* 71 Fed. 2d 100 (1934), *Stickney v. General Electric Co.,* 44 Fed. 2d 362, and such text material as is contained in 6 Am. Jur., Bankruptcy 1085, apparently completely disregards the fundamental changes wrought by Congress in Section 60 in 1938 and 1950.

The length of this brief would be doubled with little gain if the historical development of the sec-

tion as it bears on equitable liens were here traced in detail. Suffice it to say that the subject is exhaustively treated in Sections 60.37, 60.38, and 60.50 of Collier on Bankruptcy, 14th Edition. (Vol. 3.)

At the end of Section 60.50 the Editors conclude:

> "It is believed that equitable liens, equitable assignments, and the like are largely eliminated in bankruptcy by the various provisions of the present act."

Let us test this broad conclusion by applying to the instant facts the provisions of Section 60-a-6, the text of which follows:

> The recognition of equitable liens *where available means of perfecting legal liens have not been employed* is hereby declared to be contrary to the policy of this section. If a transfer is for security and if (A) applicable law requires a signed and delivered writing, or a delivery of possession, *or a filing or recording, or other like overt action* as a condition to its full validity against third persons other than a buyer in the ordinary course of trade claiming through or under the transferor and (B) such overt action has not been taken, and (C) such transfer results in the acquisition of only an equitable lien, then such transfer is not perfected within the meaning of paragraph (2). Notwithstanding the first sentence of paragraph (2), it shall not suffice to perfect a transfer which creates an equitable lien such as is described in the first sentence of paragraph (6), that it is made for a valuable consideration and that both parties intend to perfect it and that they take action

> sufficient to effect a transfer as against liens by legal or equitable proceedings on a simple contract: Provided, however, That where the debtor's own interest is only equitable, he can perfect a transfer thereof by any means appropriate fully to transfer an interest of that character: And provided further, That nothing in paragraph (6) shall be construed to be contrary to the provisions of paragraph (7). (Emphasis ours.)

The agreement found by appellant in the transcript provides, at most, that appellant would "carry" the debtor until payment was made by the State and then appellant would be paid from those funds. If this agreement gives rise to an equitable lien, were the "available means of perfecting legal liens . . . employed"? And specifically, was the "overt action (required) as a condition to its full validity against third persons . . ." ever taken as required in the section just quoted?

The "overt action" thus necessary in the case of accounts receivable is:

(a) Execution of an express legal assignment as opposed to an equitable assignment arising out of a contract.

(b) Compliance with the several provisions of Section 3019 of the California Civil Code, relating to the filing of the requisite notice in the office of the filing officer.

The record contains no suggestion whatever that the above steps were taken. It would therefore seem

manifest that whatever equitable lien may have existed in favor of appellant, it totally failed to meet the present requirements of Section 60. Closely in point is *Manchester National Bank v. Roche,* 186 Fed. 2d 817, (1951).

III. IS APPELLANT SAVED BY THE PROVISIONS OF SECTION 67-b?

Section 67-b reads in part as follows:

> "The provisions of Section 60 of this Act to the contrary notwithstanding, statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this Act by or against him."

The contention of appellant is that, by virtue of this language, a transfer, otherwise voidable under Section 60, is saved if it is given in satisfaction of a mechanic's lien on a construction project on which the debtor has expended labor and materials, since in such a case funds in the hands of the owner are "earmarked" for the materialman, and the extinguishment of the lien thus causes no true depletion of the estate. This is the position taken by a Washing-

ton District Court in this circuit in *Jackson v. Flohr*, 119 Fed. Supp. 305.

We note only in passing that the Court was dealing with Washington rather than California law and instead contend that the holding is inherently unsound. It is respectfully urged that the Court fell into error by ignoring fundamentals.

The transferred asset of the subcontractor debtor is the account receivable owed to him by his general contractor. It is still owed to him even if the owner never pays a cent to the general contractor. If he transfers the receivable to satisfy the claim of a materialman, it is obvious that he has depleted his estate, regardless of the separate security right to recover from the owner which was relinquished by the materialman.

But we do not dismiss the position taken in the *Jackson* case merely by pointing out its most obvious weaknesses. It can also be argued that Congress intended mechanics and materialmen to be protected from preference actions when a statutory lien right otherwise available to them is extinguished by the payment, *regardless of whether the lien was or was not on property of the bankrupt and hence regardless of whether or not a depletion of the bankrupt's estate resulted.* No discussion of the problem would be complete without consideration of this contention.

A. Careful Analysis of the Actual Language of Sections 60 and 67-b Will Establish That Section 67-b Is Limited to the Liens Arising on Property of the Bankrupt.

It is provided in Section 67-b that "The provisions of Section 60 of this Act to the contrary notwithstanding, statutory liens . . . may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition . . ."

And, what does Section 60, the section thus inhibited, *concern itself with?* It is the *preference* section, and it begins, "A preference is a transfer, as defined in this Act, of any of *the property of a debtor* to or for the benefit of a creditor." Section 67-b, then, is a limitation on *transfers by the debtor of his own property,* prior to bankruptcy, which can be voided by the trustee. This is the concern of "the provisions of Section 60 of this Act", which could conceivably be "to the contrary notwithstanding."

Now, the creation *by the bankrupt* of encumbrances against his property is one of the very common means of "transferring" his property. If no other limitation existed, the creation of a *statutory encumbrance* could thus constitute a voidable preference. And it is altogether logical and consistent that a limitation on such otherwise voidable transfers should have been incorporated *to protect those who may have expended labor, materials, and the like on property of the bankrupt from being classed as preferential transferees.* Considered thus the two sections dovetail together, and Section 67-b is revealed as a logical limitation on Section 60.

B. Statutory Liens on Property Other Than the Bankrupt's Are Already "Valid Against the Trustee" Without Any Aid From Section 67.

In a sense this is the converse of the analysis just completed. A trustee in bankruptcy is no more able than anyone else to attack a duly perfected statutory lien on the property of *some person other than the debtor;* it is "valid" against him because Section 60 in no way declares them *invalid* against him. Or to put it differently, there is nothing in Section 60 "to the contrary notwithstanding."

In the instant case, the mechanic's lien and stop notice rights of appellant were valid against the trustee; nothing in the decision of the trial Court, or in the *San Mateo Feed* case there relied on, holds or implies that this appellee trustee had any right whatever to invalidate the stop notice or conventional mechanic's lien rights of appellant.

What the decision does hold is that if satisfaction is accepted by the materialman from his subcontractor obligor, *in lieu of enforcing the security,* it is done with the hazard that the transfer may be avoided in the event of the bankruptcy of that obligor.

It is difficult to see that the complained-of hardship to the construction industry as a result of this rule is any greater than that suffered by a businessman in any other category who accepts payment from one whom he has reasonable cause to believe is insolvent. Indeed the materialman, clad with lien rights, has a sure and safe alternative, while his counterpart in other branches of commerce generally has none.

IV. OTHER EXCEPTIONS URGED BY APPELLANT.

Appellant deemed it advisable to discuss only two of the other exceptions made in its opening brief. We will confine ourselves to these two and will seek to achieve the same brevity.

A. Antecedency of Debt.

Again assuming the existence of the contract found by appellant in pages 81 and 83 of the Transcript, it is difficult to see where its cause is aided. The agreed-upon time for payment of a debt is not the criterion for determining antecedency. Rather the question is whether the transfer was made for a present or past consideration. Manifestly the consideration given by appellant, the materials supplied, had long since been received when the payments here involved were made.

B. Actual Insolvency at Time of Payment.

According to the figures set out in the Statement of the Case, supra, the bankrupt was indebted in the amount of $23,796.02 and had assets of $14,885.64, even assuming appellant's view as to the value of the equity in the home, the higher value of the tools, and so on. It is plain that there was abundant evidence to support a finding of insolvency against any challenge of that finding on appeal.

CONCLUSION.

It is probable that we have said essentially little more here than was said by this Court in the *San Mateo Feed* case. It was there clearly perceived that Congress intended no such special advantage as is contended for here, but rather that the protection sought to be extended lien claimants was limited to those cases where labor, materials, and the like had been expended on property of the bankrupt himself. The Court's position was sound and should be reaffirmed.

Dated, Bakersfield, California,
March 2, 1956.

Respectfully submitted,
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